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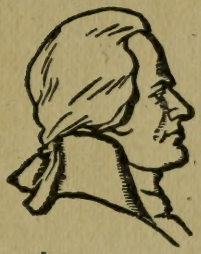
[Modern business Talks]

# TRANSACTIONS PROPERLY RECORDED

**Without clear records of business there can be no insight, and without insight, no foresight.**



MODERN BUSINESS
TALK No. 17

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ALEXANDER HAMILTON INSTITUTE
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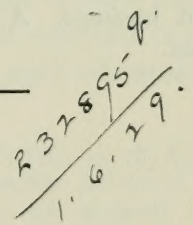
# Transactions Properly Recorded

Number Seventeen of a Series of Modern
Businesss Talks Prepared by the
Alexander Hamilton Institute



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NEW YORK

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## READING ASSIGNMENT

The current Reading Assignment consists of three parts: (1) this Talk, (2) Pages 1-185 of Volume 9, "Accounting Principles", and (3) Lecture 9.

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Those who fear that because of its technical background accounting will prove a difficult subject, should take comfort in the thought that "difficulties are made to be overcome." They look formidable because we are prone to avoid them. Face them, and their terrors disappear. Accounting is a vital part of modern business. A mastery of its principles is essential.

# Transactions Properly Recorded

> This (bookkeeping) record should be so explicit and detailed that at any time the nature and character of any transaction may be readily perceived.—Page 37, Chapter III, Volume 9, of the MODERN BUSINESS Text.

It is a good thing for the business men of today that they have better methods for the recording of transactions than had merchants of a few hundred years ago. Then the making of a bookkeeping entry was a rather tedious, and by no means simple matter.

Until the fourteenth century, books were kept in a sort of diary form, and individual entries were not infrequently as large as one-half of this page. The following is from the municipal account of the City of Edinburgh, in the year 1652, and indicates the style of entries then in vogue:

> The counter is to be dischargit of VJ for sex (6) flesche stoks (butcher meat blocks) of the personis following, quhairof (whereof) thre stands waist (three are unused), ane other occupiit be Andersoun, ane puir man, and the occupiars of the uthir twa (other two) past to the weris in France (went to the war in France) and left their stokkis waist; summa. . . . vj$^{li}$

Another is from the books of Soranzo Brothers, merchants of Venice, 1406-1434, and reads when translated into English:

Pole cat skins, which belong half to Mr. Lucha Donado, the other half to our firm, Dr. on 8th July, per Mr. Julian Loredan, for 184 skins, among which were nine marten skins at 22½ soldi, each—amount entered in the book kept by Mr. D and Mr. Jaime at page 77, in this book, page 99.
£III, XVII.

As appears from the foregoing, a set of books in those days must have been a voluminous affair. Moreover, some of the very simplest features of present-day account books were wholly lacking. Thus, until the year 1300, many of the books had no money columns at all. This was doubtless due, at least in part, to the custom of using Roman numerals, which then prevailed. When you can write one hundred with a single letter "C", or five hundred with a mere "D", but have to write LXXXVI in order to write eighty-six, it is plain enough that columnization is not of any special help when you want to foot a column.

Even after money columnization had become the regular thing, it was not unusual to enter debits and credits directly under each other without separation.

## A Simple Definition

In the first chapter of the present reading assignment, the evolution of accounting is briefly traced from its earliest history until the present day, and some of the broadly descriptive terms of accounting are defined.

At times we find that the term, "accounts", causes confusion in the minds of some, tho if properly used, the term is really very simple. Thus, when we

say that the missionary in China rendered an account of the happenings during his stay, we mean that he recited facts of opposite tendencies—some facts being favorable and some unfavorable, and that he stated the conclusion to be drawn therefrom. If the reader of this assignment will bear in mind this use of the term, there will be no confusion in that connection.

A most interesting chapter is that which deals with business profits and business capital (Chapter II). Here the subject of profits as related to investments, is discussed—the amount of the initial capital invested in an enterprise and the apportionment of outlay during any given year upon the basis of the number of units of production. The author's discussion in this chapter of the subject of interest and profit is chiefly one of economics, and will be found to make plain some points which often are not understood at all.

In Chapters III and IV, the fundamentals of bookkeeping are described from the viewpoint of their importance as a necessary preliminary to the higher functions of accounting. The former chapter deals with single entry, tracing the developments of the subject from the beginning. In the latter chapter, double-entry bookkeeping is the theme.

All books are necessarily devised for the purpose of keeping records and for determining results. The proprietor wants to know how much business is being done—how much in each department and how much

profit is made. In order to afford this information, the bookkeeping system must be made to fit the business, since obviously we cannot readily arrange our business to fit a certain system of bookkeeping. Frequently, the proprietor doesn't care to examine the hundreds or thousands of daily transactions, but he always wants to know at the end of a period what business has been done during that time, and what his present standing is as compared with that at the beginning of the period. In short, he wants to know the results.

## The Mystery of Double Entry

Sometimes there appears to be a misunderstanding on the part of some with regard to the meaning of the term "double entry", as tho it meant that the transactions are recorded twice. But "double entry", as the author shows, is simply a record that expresses at one time the two opposite facts of a transaction, namely the increase and the decrease. If we record only the increase in cash, the full story is not told; there must necessarily have been a decrease in some asset in order to produce the cash, or there must be an added liability, showing to whom we are indebted for this cash. But there is no *double entry* of the transaction.

In a certain western city there was some years ago, a house of considerable size which kept its accounts on the single-entry plan merely because it had begun in that way when it was founded. A surprisingly

large number of business concerns still use the single-entry system despite its inadequacy in most cases and despite, too, its obvious danger. The bookkeeper in that house had been in the firm's employ for many years, but he had only a theoretical knowledge of double entry. He opposed every suggestion of a change in the system. But at last the members of the firm insisted on the double-entry system being installed.

Then it was found that the accounts, as shown in the single-entry books, were in an unsatisfactory condition. They were not true reflections of the business, but instead presented a distorted image which, however, to the bookkeeper had become so familiar that it passed for the real one. Upon this incorrect image, the bookkeeper built his double entries. In less than three months the tangle was such that the firm had to call a halt. Plainly, double entry was a failure, the manager admitted, and the books must be turned back to the simple life of single entry. There was so much red tape, he said, and it was undermining the business!

But when the attempt was made to return to single entry, there was additional confusion, and eventually an expert accountant was called in. He, after an examination of the books, declared himself unequal to the task of fathoming the bookkeeper's work, and was compelled to start a set of books entirely independent of existing accounts, merely transferring to the new ledger the personal accounts and such general figures as could be checked up with a detailed

statement of affairs, specially prepared for the purpose.

When finally the new double-entry system was in full swing, the members of the firm were surprised to find wide discrepancies between the new and the old items. The amount of the proprietorship, or existing worth of the business, had shrunk thousands of dollars, while the individual interests of the partners were very different from the assumed interest under the old regime. This situation was the result of incorrect inventories, failure to enter the difference between estimated profits and actual profits, disregard of items of depreciation and obsolescence and general incompetency in stock and sales accounting. One of the partners refused to submit to what he regarded as an injustice to him, and actually proceeded to sue for an accounting. Ultimately, he withdrew from the firm, after it had narrowly escaped a receivership.

Probably the majority of small and medium-class merchants would dispute a definition of single entry which said: "This is a system of bookkeeping in which accounts are kept on a partial and incomplete basis." If it were suggested to them that their own books were in all stages of incompleteness, they would probably grow indignant. Yet very probably that would be the exact truth.

Chapters V and VI are devoted to a description of the various books and their functions in the scheme of bookkeeping, and to the classification of accounts. These are excellent expositions of the principles that

underlie all intelligent accounting procedure, and will be enjoyed alike for their own value and for the simplicity of their presentation. In the latter chapter, accounts peculiar to the corporation as well as those that fit the sole ownership or the partnership form of business are mentioned, and it is well that these distinctions should be clearly understood.

## Partnership Accounts

Especially in partnerships, serious financial losses have been suffered by innocent members of failing concerns thru a faulty or incomplete accounting system.

Some time ago, a young man, William Merwin, in a New England town, bought an interest in a retail dry goods business, for which he paid in cash a little less than $4,000. Before the end of the first year of his partnership, the business was thrown into bankruptcy. This was all the more regrettable as the investment on his part represented the savings of a number of years.

Now, on the face of it, Merwin was not responsible for the debt of the old firm before he became a member. His responsibility began on the day that he paid over his money and became the third partner. Theoretically, all he had to do was to go into court and show that the store had not lost any money or created any debts of consequence since his admission, and that the failure of the business at this time was caused by old liabilities.

But theory and practice do not always agree—especially in partnerships. At any rate neither Merwin's lawyer nor his public accountant was able to prove to the satisfaction of the court that the insolvency of the firm dated back, as was claimed. The books did not show it.

## Penalty of Ignorance

In fact, the books, when they were examined in court, did not show much of anything tangible. About the only thing of importance that they did show, was that the partners were woefully ignorant of the art of partnership accounting. Not only that, but it was also brought out that they were equally ignorant or incompetent with regard to the management of their partnership affairs. Apparently none of them had any clear conception of the various problems involved in that relationship.

There were practically no accounts worthy of the name, except the purely personal ones of creditors and customers. The capital interests were in a tangle with the drawing account of the members of the firm. There had been temporary advances by one of the partners and temporary loans to another. Just where the "temporary" element began and where it ended, it was no longer possible to say. It was just as impossible to define certain losses thru shrinkage and mark-downs in goods; nobody could tell from the books when those losses commenced, whether before or after the change in the partnership.

Furthermore, the item of depreciation had never been seriously considered in the accounting, and even a long dispute in court failed to establish with any definiteness what should and what should not have been done. There was another clash between the lawyers on the subject of good-will. What had been the good-will of the old firm when Merwin invested his $4,000? Nobody could tell.

The court held that since matters were in such a hopeless confusion Merwin was to be regarded as equally responsible with his partners for the failure. The unfortunate investor lost his $4,000.

The pitfalls in partnership accounting are many, and every day men are being rudely awakened from their fancied security. In all kinds of business, there are those who are equally unable to tell where they stand. The grind of the law court attests the truth of this statement.

Partnership accounting involves no new system of accounts, nor is there any deviation from the principles of accounting set forth in the chapters of our assignment. It is simply a question of modification to allow for new factors; or, to state it in another way, it is a sub-division of the proprietorship into various accounts according to the number of partners. If it is clearly understood in each case just what contract has been made between the partners, there is ordinarily little difficulty in formulating the accounts.

It is only common sense to say that the business man should know at all times where his business

stands, both in relation to his creditors and to his partners. To this end, he needs exact and trustworthy accounts.

## Corporation Accounts

Chapter VI of the present reading assignment is devoted in part to the corporation and its accounting records. A few special accounts are necessary, tho no new system is involved. It is simply a case, as with a partnership, of considering, analyzing and recording these extra factors.

As compared with the simple bookkeeping of a partnership, that of a corporation may at first appear decidedly involved. Once the exact plan of organization is understood, however, the accounting is seen to be comparatively simple. The process is, moreover, genuinely interesting.

Frequently a corporation is formed because the business has outgrown the old partnership form. This was the case in the incorporation of the Baldwin Locomotive Works of Philadelphia, from the old firm of Burnham, Williams & Company. The rapid growth of the business made it necessary to obtain control of the raw material, in order that manufacturing operations might be conducted with the greatest amount of economy. Moreover, the great railroad activity in the West had produced competitors in that part of the country. To meet this competition, it was deemed necessary to have a branch plant in that territory. Since the vastly

enlarged business could not conveniently be carried on as a partnership, the only solution lay in turning it into a corporation.

### Confusion of Terms

To some, the exact meaning and significance of the terms employed in corporate organization and accounting are somewhat hazy. Chapter VI explains some of the terms.

The capital account, for instance, has its peculiar significance in corporations, a fact which is more and more evident as later in the Course one studies the subject of Corporation Finance. Increases and decreases of capital stock assume such importance that they are not allowed without due control. The meaning of controlling accounts needs special explanation and requires some study in order to be correctly understood and the term rightly used.

A common confusion of terms is that between treasury stock and unissued stock. As will be recalled, the author of Volume III explains that stock which has never been issued is not treasury stock. The latter is stock which has actually been issued, and which subsequently has come into the possession of the corporation in payment of a debt or thru one of a number of possible contingencies. Treasury stock is worth its market value, and should be carried on the books either at par or at the market value. Unissued stock has no value.

An interesting case of misconception of this sort occurred in the accounting of an eastern thread

concern a few years ago. There were on hand seventy-five shares of unissued stock of a par value of $100 each, which were being carried on the books of the corporation as "treasury stock", but on which dividends were not being paid. One stockholder who owned just one share was inclined to be troublesome, for which reason the corporation bought back his share at a $50 premium and put it back with the "treasury stock." But the accountant was uncertain as to the proper method of recording this transaction. Good money had been paid out for this single share, so that dividends ought to be paid on it. Yet, was it good accounting to pay dividends on one's own stock to oneself? And if so, how should he reconcile it with the other seventy-five shares of "treasury stock?"

As a result of an inquiry that he made, he learned for the first time the difference between unissued stock and treasury stock. He learned, too, that the share of treasury stock about which he was troubled, should be carried in the records of the company at its present market value or at par, which in this case happened to be the same, and that the balance should be charged against surplus.

Inaccuracies of this sort not only lead to misunderstandings and misinterpretations of the records themselves, but frequently bring discredit on the corporation, as if it were the intention of the latter to deceive the public as to the true state of affairs. Especially is this the case when there is reason to believe that the directors desire to conceal "water"

in the capitalization or to tuck away undesirable items under peculiarly worded headings.

### Four Important Chapters

The next chapter in our assignment (Chapter VII), under the title "Posting Media", describes the manner in which transactions are carried to the ledger and the sources whence the individual items are obtained. Among other things, the author shows how, by means of columnization, transactions may be classified without the use of additional books and the total of each carried to a single account at the end of the month.

Chapter VIII discusses valuations for recording purposes, and Chapter IX describes that important part of every modern accounting system—the trial balance. That chapter is followed by one on so-called economic accounts and their relation to the financial statement—the last chapter in the present assignment.

### A Question of Policy

Sometimes a question arises as to whether in the case of a holding company, products and materials transferred from one of the subsidiary companies to another should be charged at cost or at the market selling price, and how such a transaction should be entered on the books of the subsidiary companies and on those of the holding company itself.

A case of this sort came up in connection with the accounting of a paper house in northern New York.

The company owns two mills which we will call A and B. A is a combined paper and pulp mill, while B is a pulp mill only. A, however, does not produce pulp sufficient for its own paper department, and the company has to bring additional pulp from mill B. The balance of the product of B is sold to the trade at a price of three cents a pound delivered. On the books of the company mill B is given credit for all the pulp it ships A at the regular market price of three cents delivered, and the paper department of A is charged with the pulp at this price. At a recent inventory period, mill A had in stock 50,000 pounds of pulp from mill B. The pulp cost the company at mill B 2.5 cents; the freight from B to A was ten cents per hundred pounds. Should the pulp be carried in the inventory at 2.6 or at 3.0 cents per pound?

Upon studying the question, the fundamental principles were found to be clear and definite. The two mills are for all practical purposes run independently; consequently the accounting system should show the net profit of each, as well as the comparative efficiency of the plants. This being the case, mill B is entitled to all profits made on the pulp shipped to mill A. The inventory of the pulp in mill A should therefore be carried at its market value, namely, three cents per pound, since the profit thereon belongs to mill B, and the profit and loss statement of both mills should show the transaction at this figure.

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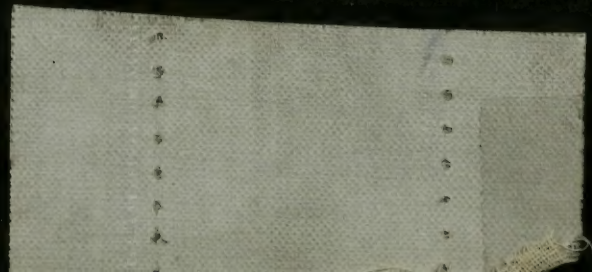

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